$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS INC.

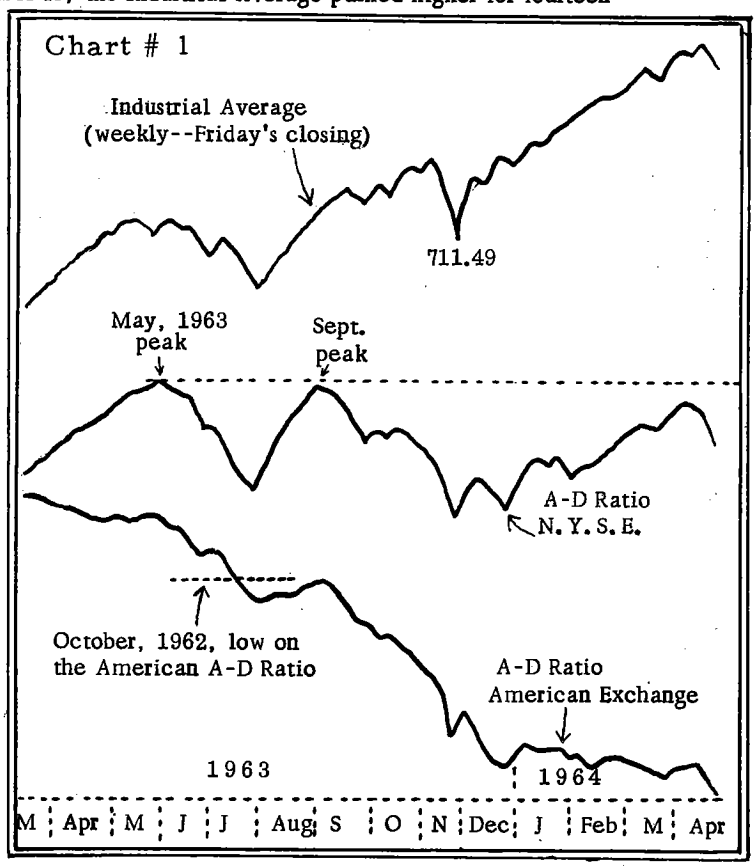
"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
P. O. Box 15196
San Diego 15, California

Registered with the Securities and Exchange Commission

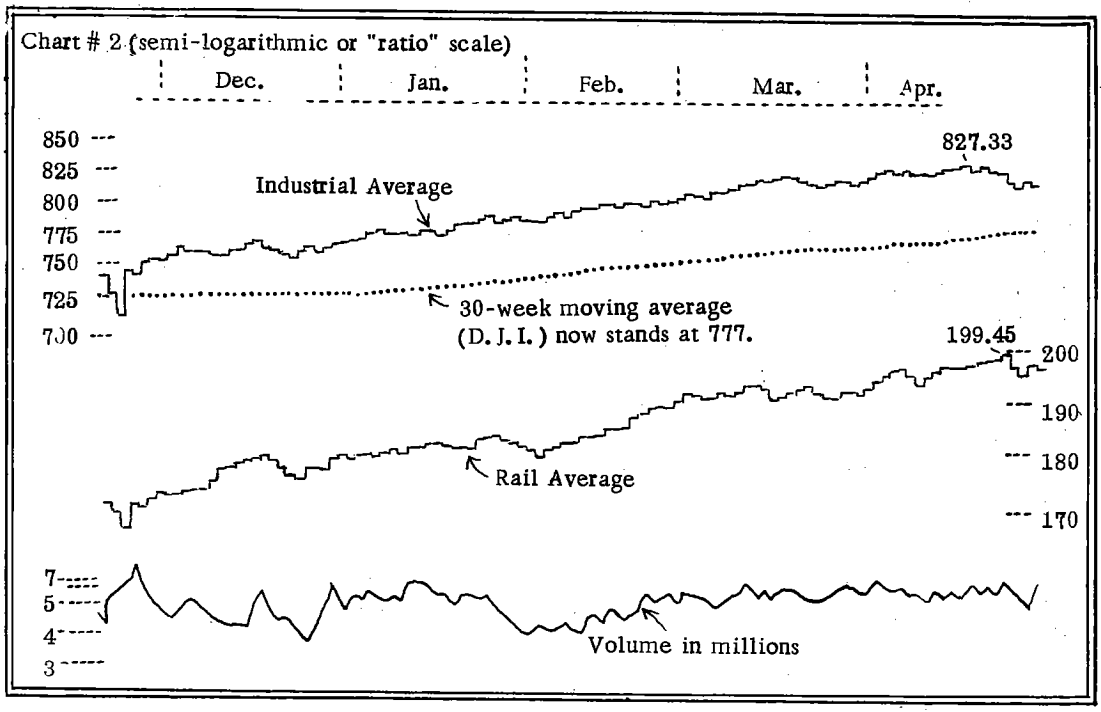
All Rights Reserved

THE MARKET: Following the "assassination lows" of late-November, the Averages turned up and began a remarkable advance. Except for the minor 7¢ decline during the week ending December 13, the Industrial Average pushed higher for fourteen consecutive weeks. The period of November 13, 1963, to March 6, 1964, in fact, produced a record for continuous advance in the senior Average which is unequalled in market annals. Perhaps because of the persistance of the advance, professional opinion turned almost unanimously bullish at the March-April highs.



Nevertheless, history suggests that extraordinary advances can give way to extraordinary (or at least extraordinarily violent) declines. While it is too early to know for certain, something of this nature could now be in the offing. On March 18, Industrials struck a high of 820.25. A period of irregularity ensued, followed by a further rally to an all-time Industrial high of 827.33 on April 17 (see Chart 2). It is worth noting that during the period of March 18 to April 17, Industrials tacked on only 1% but an impressive total of 118 million shares changed hands. Such action constitutes "churning", and this phenomenon was noted in these Letters.

Despite general market weakness, the Rail Average extended its advance four days beyond the April 17 peak in the Industrial Average. On April 23 Rails touched an historic high of 199.45. This obvious divergence was accompanied by broad churning on April 23, a day which saw volume at 6.7 million shares, Rails at a new high and Industrials and most stocks down. On April 24 a violent decline battered almost every segment of the market, and by the close Industrials had dropped below their March peak. April 27 saw a continuation of the decline on lower volume, followed by a rather weird low volume recovery on April 28 in which Texas Gulf Sulpher made up a full 10% of the N. Y. S. E. transactions.



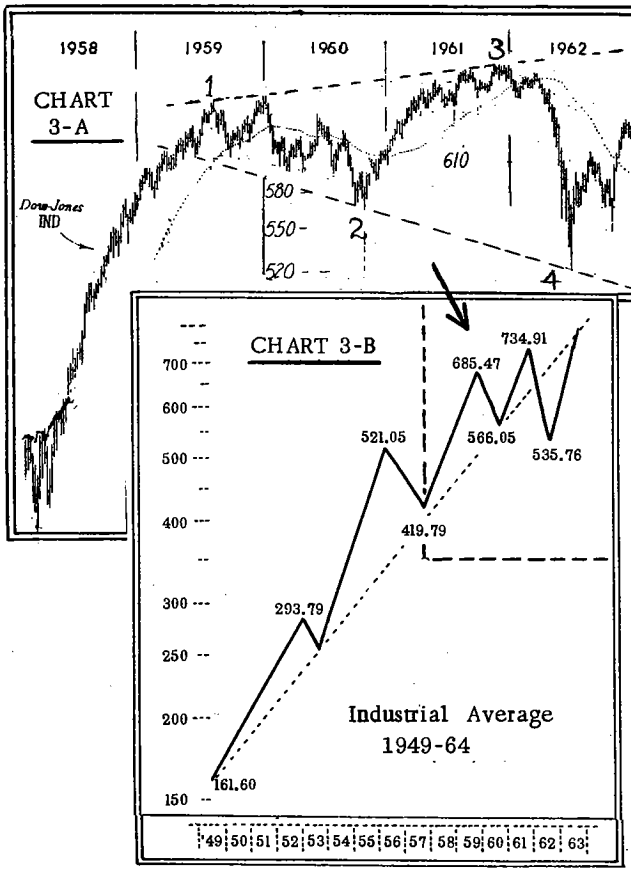
Many readers have written to ask whether I believe a secondary reaction or indeed a full bear market can now have started. There is absolutely no way of telling at this time. On April 27 Industrials recorded a low of 811.87, Rails a low of 194.94. On the same day odd-lotters switched to fairly heavy selling and odd-lot shorts expanded sharply. This suggests that the public

 is quick to frighten on the decline, and as long as this continues it constitutes a good argument in favor of the bulls. The lows of April 27 are our first important check point. As long as one or both Averages hold above these lows, I would suggest that bearishness be held in abeyance. A high-volume penetration of the 811.87 and 194.94 levels, however, would place the market in an ominous light.

* * * * *

Chart 1 (page 1) traces the strange relationship of the Industrial Average and the mass of stocks as measured by the advance-decline ratios during the period from March, 1963, to the present. Note on the chart that the A-D ratio (N.Y.S.E.) recorded its high in late-May, 1963, but since then it has made little important upside progress. Twice the ratio has approached the May, 1963, peak; each time it has turned down. The latest approach occurred on April 6. This was followed by a minor decline, and on April 17 Industrials climbed to a new high -- a high which the A-D ratio refused to confirm. This technical failure gave way to the sharp market break of April 23-24. On April 24 (see chart) the A-D ratio sank to its lowest level since February. The February level, in turn, is approximately equal to the level of the A-D ratio a year ago. All of which constitutes the type of technical action which veteran market practitioners dislike; it is calculated to produce as many losses as profits, and it is characteristic of prolonged periods of distribution.

On the American Exchange the long decline continues. Last week the A-D ratio on the Amex broke to a new low for the entire 1962-64 move. (For reference purposes the chart indicates the level of the Amex A-D ratio at the 1962 crash low).



BIG PICTURE: Chart 3A traces the path (weekly) of the D-J Industrial Average from 1958 to the present. Here we see the five major swings which have taken the Industrials to successive highs and lows over the past seven years.

Because of the symmetry of this series of extraordinary movements, I have likened the whole structure to one massive "broadening pattern", and I have suggested that readers pay particular attention to what occurs if and when the Industrial Average touches the upper trendline of the formation at point 5. Currently, the senior Average has pushed just beyond the upper ascending trendline, but as seen on chart 3A (which is scaled to semi-logarithmic proportions) the Average still is not completely out of the "grip" of the four-year trendline which connects the peaks of 1959, 1961, and 1964.

Chart 3B illustrates the entire rise from 1949 to 1964 — again scaled to semi-logarithmic proportions. The 1958-64 period, which is shown in detail in Chart 3A, appears as a section of Chart 3B (arrow points to the 1958-64 section).

Chart 3B is of particular interest to the long-term investor. Consciously or unconsciously, the long-term investor is guided by the type of thinking which caused Robert Rhea to write: "I have always regarded 'investing' in stocks to mean acquiring equities of sound value in times of depression and holding for dividends and appreciation until prices have exceeded a reasonable line of values."

It is rather startling to note on Chart 3B that the great bulk of the advance since 1949 (in terms of percentages) took place between the 1949 low of 161.60 and the 1960 high of 685.47. The swings since 1960 have occurred within the top one-third of the chart, and their frequency and complexity strongly suggest that the average investor might easily have lost as much as he made during that period.

The attribute required by both traders and investors at this point is patience. The trader needs patience because stocks have now advanced to the point where the odds favor an opportune trading buy-point somewhere ahead — rather than substantial further further profits on a rise from this level. The investor needs patience because although it may now seem "impossible", all periods of overvaluation are followed by periods of undervaluation — areas in which good stocks "go begging" on the bargain counter.

THE AVERAGES: When I first started writing these Letters, the mere mention of the "predictive value of the Rails" brought snickers from both the public and the Wall Street analysts. But during the past five years the value of the Rails and the value of the whole Dow Theory confirmation principle has become so fully accepted that I again feel that ill-founded "chatter" has taken the place of research and facts.

Today one is given to understand that "as long as the Rails are leading the way, the Industrials will follow and the market will go higher." As far as Dow's Theory is concerned, the Rails possess no more or less predictive ability than Industrials. There have been a number of instances wherein both Averages established simultaneous peaks and turned down together, and there have been times when Rails turned down after a major Industrial top. For instance:

(1) On September 3, 1929, Rails recorded a peak of 189.11, Industrials a peak of 381.17. Those joint highs proved to be the ultimate peaks for the 1921-29 bull market.

(2) On March 10, 1937, Industrials recorded a high of 194.40; Rails continued to climb, however, establishing a bull market high of 64.46 on March 17. The new (unconfirmed) Rail high proved to be deceptive, and the March 10 Industrial peak marked the final top.

(3) On May, 1946, Industrials touched a bull market high of 212.50. Rails pushed to an (unconfirmed) bull market high of 68.31 on June 13, 1946. Despite the new Rail high, the earlier Industrial peak proved to have marked the end of the 1942-46 bull market.

(4) In 1948 Industrials struck a peak of 193.16 (June 15). Rails continued on to an (unconfirmed) high of 64.95 (July 14). The earlier Industrial high proved to have been the baby bull market top.

(5) On July 12, 1957, Industrials reached a high of 520.77. Rails rose to a high of 153.81 on July 25, 1957. Those who believed the unconfirmed Rail high boded well for the stock market were doomed to disappointment. The July 12 Industrial peak marked the 1957 market high, and a very costly decline followed.

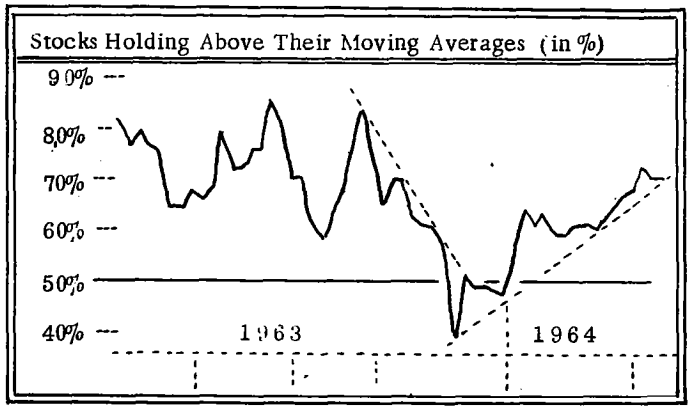
Moral: (1) Watch both Averages. Neither one possesses more predictive authority than the other. (2) Each successive upside (or downside) confirmation holds less validity than the last. For instance, in a bull market there must be a final upside confirmation by the two Averages — and this will be the last one prior to a new bear market. Thus, the last confirmation (in retrospect) will have been "false" and those hopefuls who bought stocks on the basis of the final confirmation will then denounce Dow's Theory as deceptive. The last penetration is (and obviously always will be) "deceptive".

QUESTION: Why does the average yield on the Standard & Poor 425 Industrial Stock Average and on the Moody 125 Stock Average differ from that of the D-J Industrial Average?

ANSWER: At present, the yield on the Dow is 3.2%, while the yields on the S & P and Moody Averages have sustained one of their rare (and dangerous) dips below the 3% level. The disparity in the indexes stems from the fact that both S & P and Moody calculate dividend yields on the basis of cash dividends alone — while Dow Jones includes stock dividends as well (the current Dow yield includes $3.07 worth of stock dividends). Stock dividends represent a return of capital, and if such dividends are sold the seller sustains an actual loss of equity in the given companies. The spending of cash dividends, however, does not change a stockholder's equity position. For this reason I have never felt that stock dividends should be included in yield calculations. On this basis, all averages are now on a yield of 3% or less.

LATE NOTES: Following April 28's dull recovery on 4.7 million shares, a sharp decline on April 28 brought out surprising downside volume of 6.2 million shares. Thus, for the first time volume is tending to expand on declining days and contract on advancing days — a bearish indication. On April 28, also for the first time this year, the 5-day average of daily new lows rose above the 5-day average of daily new highs. Meanwhile, the market continues to be generally unresponsive to the barrage of optimistic business news. If the current weakness develops into a major decline, it will have particularly interesting connotations. The reasons: (1) this time the professionals and the funds will be the ones to take the beating. The public has never shown anything but the most passing interest in the 1962-64 rise. (2) if a major decline now materializes, it will have started with almost every investment service promising its readers that "any correction will be both shallow and short-lived".

STOCKS: Of 432 representative issues which are tabulated weekly at this office, 113 (70%) are now holding above their 30-week moving averages — no change from last week. As seen on the chart, the bullish percentage indicator is touching the rising trendline. A penetration of the trendline would suggest an important decline in the bullish percentage.



Although I hesitate to recommend even trading commitment at this time, Elgin National Watch is now of particular interest (chart on page 4). The huge ascending triangle in this stock was discussed in Letter 250. Last week ENW broke out of the triangle (despite a poor market) as news of an impending proxy fight was announced. The fundamentals of ENW are interesting. The stock has a book value of over $20.00 per share. Company sales for the full year ending February, 1964, will probably be up about

40% over the previous year. Earnings could amount to $1.50 to 1.75 per share, and thus the stock is selling at a low price-earning ratio. An interesting speculation, fundamentally and technically.

At what point does one "throw in the sponge" on a stock? Technically, Sperry Rand provides a good lesson in when to "give up". In late February (price 20) SY's upward relative strength (R.S.) channel was broken. An early indication of distribution is a stock's inability to keep up with a rising market; for this reason it is not unusual to witness a breakdown in R.S. before a breakdown in price. Thus the penetration of the R.S. channel in SY was sufficient to justify selling. The early R.S. warning was confirmed three months later when SY broke (last week) below its major rising trendline.

Can a stock rise to new highs for the year and still look poor? The answer is yes, and on the chart of General Electric we see what appears to be a large "rising wedge" pattern. The peak of upward momentum occurred in very late 1962, and from then on, despite a continued slow rise, the stock acted poorer than the market (as seen by the decline in R.S.) Such action is usually a sign of distribution, and the stock will often show its underlying weakness on the first important market break.

Groups which are displaying an improvement in R.S. are machinery and machine tools, aluminums, mining and smelting, and tobaccos. The two-year decline in tobacco R.S. can be seen reversing on the chart below. Deteriorating R.S. is being shown by the bank stocks, finance stocks, small loan companies, aerospace, autos, coal, textile apparel.

Chart 3A courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Charts of ENW, SY and GE courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003. Chart of Tobacco R.S. courtesy of Ray * Signals, 141 Broadway, NewYork 6, New York.